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TAGS: [ECON](#) [EAID](#) [CE](#)
SUBJECT: SRI LANKA: IMF NEGOTIATIONS COMPLETE; GSL MUST ACT

REF: A. COLOMBO 285
[1](#)B. COLOMBO 244

Classified By: Ambassador Robert O. Blake, Reason 1.4 (d)

[1](#)1. (C) Summary: The IMF team negotiating a stand-by agreement with the GSL returned to Washington on April 1 with GSL-agreed language for Sri Lanka's Letter of Intent (LOI) and a hope that the government will demonstrate it is ready to take necessary steps to put the economy back on track. The proposed stand-by facility totals USD 2.5 billion; the draft agreement includes a requirement to keep the 2009 deficit at 7 percent and to stop artificially propping up the rupee. Central Bank Governor Nivard Cabraal told Ambassador on April 2 that the signed LOI will be sent within days to the Fund. End Summary.

[1](#)2. (C) Econ Chief met with Deputy Directors of the IMF's Asia and Pacific Department Kalpana Kochhar and Brian Aitken on March 31 to receive a read-out of IMF negotiations with the GSL. Kochhar, Aitken and their team planned to return to Washington on April 1, following a final meeting with Central Bank Governor Nivard Cabraal. Aitken stated that IMF team would return to their headquarters with GSL-agreed letter of intent language.

Agreement Scope

[1](#)3. (C) Kochhar and Aitken reported that, rather than the USD 1.9 billion requested by the GSL, the IMF is proposing an overall USD 2.5 billion stand-by facility to the GSL because, as Aitken put it, quote this is what they need end quote. The facility would likely include an initial disbursement of twenty percent, with fifty percent of the allocation being distributed within year one. Kochhar reported that the proposed agreement sets performance measures for government expenditure (particularly concerning poor-performing state-owned enterprises) and revenue collection, and holds the government to a 2009 deficit of around 7 percent. The IMF and GSL also agreed to a path for a build-up of reserves.

[1](#)4. (C) Aitken underscored that government action on the overvalued rupee is needed immediately. The exchange rate was discussed at length both in technical discussions and with the President, Cabraal, and Basil Rajapaksa, Senior Advisor (and brother) to the President. Kochhar reported that the President did not seem surprised when the IMF advised that the rate should realistically be as low as 130-140 Sri Lankan Rupees (SLR) (vice a rate of 114/115 at the start of negotiations) to the US dollar. The GSL informed the IMF that it would cease interfering with the exchange rate and let the SLR float. In a meeting with the Ambassador on April 2, Cabraal confirmed the SLR is now floating freely.

[1](#)5. (C) Kochhar noted that the draft agreement also includes a

GSL-requested financial sector package, which will include addressing how to cope with the expected rise in non-performing loans as well as mechanisms to deal with problem banks and financial institutions.

Next Steps

16. (C) Cabraal told Ambassador on April 2 that the government will submit a signed LOI within days and hopes the IMF will take up Sri Lanka's request by as early as April 15. Kochhar and Aitken were clear that until there is a quote meaningful rate movement end quote the team will be unable to move forward to ultimately present the request to the IMF board. In their estimation, meaningful would likely be defined as around an eight to ten SLR drop from the current rate. The team plans to monitor the exchange rate in coming days/weeks. The IMF also hopes to see some recognition -- at least privately -- from GSL leadership that they understand the economics of both how the GSL got to its current state and why these measures are needed to stabilize the economy. With upcoming local and Easter holiday breaks, IMF Asia and Pacific Department Senior Economist Ebrima Faal, who remains in country, noted that it is unlikely that any meaningful action will occur until after the WB/IMF meetings in Washington April 25-26.

COMMENT

17. (C) The IMF team left Colombo with a sense that they have done all that they can to help the government put together a workable plan to stabilize its economy, and to help political leaders who lack even a basic understanding of macroeconomics understand why the government needs to act now, lest the government run out of money. (Note: Kochhar noted that, by IMF estimates, this could happen as early as August.) Aitken remains upbeat and hopeful that the GSL will play ball, in particular because he believes the President was responsive to the Fund's arguments and, as Aitken correctly noted, quote he calls the shots end quote.

18. (C) The necessary choices, however, are not easy ones for this social-welfare state to make. It will take significant fiscal restraint by the government to stay at or below a 7 percent deficit as key revenues (including exports and remittances) decline. There will also be strong pressure to increase expenditures on reconstruction of the North following an end to the war there.

19. (C) A contentious provincial election in Colombo on April 25 means that the GSL will likely not/not take drastic economic measures that could draw criticism. This means -- and Cabraal confirmed -- that a rupee devaluation will take place slowly so as to avoid opposition claims of the GSL bowing to IMF conditions. Cabraal also contends a slow devaluation is needed to "avoid panic in the local financial system." As a result, the IMF may not be prepared to take Sri Lanka's request before its Board until late April or early May.

BLAKE